ST 01-0228-GIL 10/26/2001 MISCELLANEOUS

This letter discusses sales of computer software, nexus issues and local taxes. See 86 Ill. Adm. Code 130.1935. (This is a GIL).

October 26, 2001

Dear Xxxxx:

This letter is in response to your letter dated August 17, 2001. The nature of your letter and the information you have provided require that we respond with a General Information Letter, which is designed to provide general information, is not a statement of Department policy and is not binding on the Department. See 2 Ill. Adm. Code 1200.120 subsections (b) and (c), which can be found at http://www.revenue.state.il.us/legalinformation/regs/part1200.

In your letter, you have stated and made inquiry as follows:

It is hereby requested that an expeditious review of this taxability request be granted in order that accurate advice be given to patrons of your state.

Company X is in the business of selling software licenses and providing related services.

General Overview & Contract Language Fact Pattern:
The software is canned software. Various modules are available to potential clients for purchase. All sales of software and services are contractually initiated for purposes of providing an internal audit trail. Billings/Invoices to clients are based upon signed contracts. The customer will receive separate invoicing for License fees and Continuing Support fees. A sale of software creates what is regarded as the master agreement. *Initial* support services are given to clients for a period of one year. *Initial* support will include use of reasonable diligence to confirm the existence of and correct errors in the system, provide reasonable telephone consulting support in the use of the system. Upgrades are primarily delivered to the client via, tangible media, but on occasion may be electronically transmitted and/or downloaded by the client, via an FTP site. In each case, support, customization and/or tailoring is only provided to customers that have purchased the standard software product of Company (X).

The master agreement will generally include standard language that discusses initial support services, continuing support services and cost for an additional period of time, usually three years, after the initial support has expired. A paragraph will generally read as follows:

Continuing Support Services & Costs.

Following the Initial Support period described in Paragraph 5, *Company will continue to provide the Support Services described in paragraph* 5 *and exhibit X for a period of three years. As part of Continuing Support Services, Customer will be provided from time to time with new releases of the System containing updates or enhancements which, Company generally provides to its support service customers. The annual charge for these Continuing Support Services is (X) percent of the Total License Fee of the System. All software updates will be handled through one central point of distribution at the Customer's site. Customer agrees to pay annually in advance for such services. Upon the expiration of the initial (X) years of Continuing Support Services, the provisions of this Paragraph shall continue from year to year unless either Company or Customer shall cancel Continuing Support Services by providing the other party with at least (X) days of written notice prior to the anniversary date of the commence of Services. The annual charge for Continuing Support Services after the initial (X) year agreement may not increase more than (X) percent annually. The License grant will survive any termination of the Continuing Support Services.*

Maintenance & Upgrade Questions:

Does your state make a distinction between mandatory maintenance and optional maintenance?

How is mandatory maintenance defined? What is the taxability?

How is optional maintenance defined? What is the taxability?

Are the sales of canned software with "mandatory support services that includes upgrades on tangible media" taxable?

Are the sales of canned software with "optional support services that includes upgrades on tangible media" taxable?

Are the sales of canned software with "mandatory support services that includes upgrades electronically transmitted" taxable?

Are the sales of canned software with "optional support services that includes upgrades electronically transmitted" taxable?

What are general guidelines that may be followed in determining optional support services versus mandatory support services?

Continuing Support** F**act Pattern** & **Questions:
When continuing support service is first optional to the client, and the client signs an agreement to accept additional support for a period of six months or more, does the fact that the customer signed a binding agreement with Company (X), change the status of continuing support services from optional to mandatory?

As related to the paragraph below, are *"Continuing Support Services and Costs"* mandatory or optional?

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As related to the paragraph below, are *"Continuing Support Services and Costs"* mandatory or optional?

Upon the expiration of the initial (X) years of Continuing Support Services, the provisions of this Paragraph shall continue from year to year unless either Company or Customer shall cancel Continuing Support Services by providing the other party with at least (X) days of written notice prior to the anniversary date of the commence of Services. The annual charge for Continuing Support Services after the initial (X) year agreement may not increase more than (X) percent annually. The License grant will survive any termination of the Continuing Support Services.

In cases when there is first a contract between Company (X) and its customer, and invoicing is based upon amounts detailed in the contract, does the state look to the contract for taxability or does the state look to invoicing for taxability determination?

Substantial vs. Non-substantial Software Change Fact Pattern & Questions:
Each module sold by Company X may consist of one million or more lines of code, customers may request for assistance in *Tailoring* the software for their specific organizational requirements. For instance, a certain data field my have a maximum length of thirty characters, but the client has the need to increase the field size to seventy-five characters. Company X has in-house utility programs that may be used to accommodate the client and will be provided at an additional fee initiated by a contract for Tailoring. While there is modification to the code through the use of an in-house utility program and possibly some maintenance changes to the program, there is not substantial change to the standard product.

Question:
Are less than substantial changes to the standard software product taxable when there is a separate contract and the customer is invoiced separately?

Are substantial changes to the standard software product taxable when there is a separate contract and the customer is invoiced separately?

Are charges for Tailoring the standard software product to customer specification considered as software customizations?

What is a general guideline that may be followed when determining if such services are substantial vs. less than substantial?

Custom Modification Fact Pattern & Questions;
Company (X) agrees to grant customer the right to use Company's Software Custom Modifications, consisting of the computer programs and documentation. Company agrees to provide services relative to the design, programming, testing, documentation

and training at negotiated billing rates. Customer will be invoiced separately based on amounts detailed in the contract agreement.

Additional software modules that did not previously exist prior to the contract with a client may be written from scratch to work in conjunction with the standard software module. These custom programs are written at the customers request and may include maintenance services. Company (X) retains ownership of license agreements.

Questions:

Are customized programs/modules created at the customers' request considered as new customized programs 'from scratch' even though it will be integrated with a base software product?

Are customized programs/modules created 'from scratch' taxable when Company (X) retains ownership of the license agreement?

Are customized programs/modules created 'from scratch' taxable when Company (X) does not retains ownership of the license agreement?

When there is an existing software product and customized programs are written that cause a substantial change to the standard software product, what is the taxability of the customized portion of the contract when separately invoiced?

When a customized agreement is being negotiated and it concludes with an associated maintenance agreement that extends support for a period of one year or more, is maintenance considered to mandatory or optional?

When there is a single contract, but separately stated invoicing for customized programming and mandatory maintenance, is the mandatory maintenance taxable? Will separate contracts change taxability?

When there is a single contract, but separately stated invoicing for optional maintenance, is the optional maintenance taxable? Will separate contracts change taxability?

Are the sales of customized software with 'mandatory support services that includes upgrades on tangible media' taxable?

Are the sales of customized software with 'optional support services that includes upgrades on tangible media' taxable?

Additional Custom Modification Fact Pattern;

Special contract circumstances may arise where both a Master Contract for canned software and a Custom Modification software license agreement may both be signed on the same day. Each contract will be separately invoiced. The custom software contract, however, will consist of special language referencing the master contract.

The custom software license will include a paragraph that gives the customer the right to return all software, including the standard software product that was sold under a different contract, but the same related project scope, if requirements have not been

met by a predetermined date. The customer shall receive a full refund for software and services as full and liquidated damages.

Paragraph Example:

The foregoing not withstanding however, in the specific event that Company fails to deliver by <date> the enhancements described as <description of customization> under <contract number(s)> (functioning as per the specification documents provided herein unless changes are mutually agreed to by both parties) then at Customer option, Customer may terminate this agreement and return all software delivered and shall be entitled to a payment equal to the amount of the sum paid to Company for software and services for the <project> Project as full and liquidated damages. ,

Questions:

Will the above referenced contacts be treated as separate contracts or as one single project for taxability purposes? Again, two separate contracts as well as separate invoicing, signed on the same day, same project scope.

Per paragraph example above, found only in the Customized contract, does the reference to the Master contract regarding damages and refunds change the taxability from separate contracts to lump sum contracts?

Nexus Fact Pattern:

Company (X) has various salespersons working throughout the country from their home offices. Salespeople may accept customer orders from their home office. No inventory is maintained in the home office of the salesperson. Orders are forwarded to headquarters, which is located out of state, for acceptance.

Question:
In determining whether to collect a local sales tax or possible use tax in your state, will the salesperson's home office be considered a 'Point-of-Order-Acceptance' and should a local sales tax be collected instead of a sellers use tax?

Local Tax Allocation:

Question: How are taxes allocated on the local level for report purposes when making sales from city to city, county to county, and so forth as a retail outlet with delivery trucks? Are taxes collected based on the 'Ship-From' a origination based tax or the 'Ship To' a destination based tax.

Should anyone in your organization need clarity on any of the questions we are attempting to address, please feel free to contact me.

The Retailers' Occupation Tax Act imposes a tax upon persons engaged in the business of selling at retail tangible personal property. 35 ILCS 120/2. The Use Tax Act imposes a tax upon the privilege of using in this State tangible personal property purchased at retail from a retailer. 35 ILCS 105/3.

Generally, sales of canned computer software are taxable retail sales in Illinois regardless of whether the software is transferred by disk or electronically. See 86 Ill. Adm. Code 130.1935. However, if the computer software consists of custom computer programs, then the sales of such software may not be taxable retail sales. See Section 130.1935(c).

Custom computer programs or software are prepared to the special order of the customer. The selection of pre-written or canned programs assembled by vendors into software packages does not constitute custom software unless real and substantial changes are made to the programs or creation of program interfacing logic. See Section 130.1935(c)(3).

Retailers' Occupation Tax and Use Tax do not apply to receipts from sales of personal services. Under the Service Occupation Tax Act, servicemen are taxed on tangible personal property transferred incident to sales of service. The purchase of tangible personal property that is transferred to service customers may result in either Service Occupation Tax liability or Use Tax liability for the servicemen, depending upon which tax base the servicemen choose to calculate their liability. Servicemen may calculate their tax base in one of four ways: (1) separately stated selling price; (2) 50% of the entire bill; (3) Service Occupation Tax on cost price if they are registered de minimis servicemen; or, (4) Use Tax on cost price if the servicemen are de minimis and are not otherwise required to be registered under Section 2a of the Retailers' Occupation Tax Act. If a service is provided in which no tangible personal property is transferred, then tax is not incurred.

If transactions for the licensing of computer software meet all of the criteria provided in Section 130.1935(a)(1), neither the transfer of the software or the subsequent software updates will be subject to Retailers' Occupation Tax. A license of software is not a taxable retail sale if:

A) it is evidenced by a written agreement signed by the licensor and the customer;

B) it restricts the customer's duplication and use of the software;

C) it prohibits the customer from licensing, sublicensing or transferring the software to a third party (except to a related party) without the permission and continued control of the licensor;

D) the licensor has a policy of providing another copy at minimal or no charge if the customer loses or damages the software, or of permitting the licensee to make and keep an archival copy, and such policy is either stated in the license agreement, supported by the licensor's books and records, or supported by a notarized statement made under penalties of perjury by the licensor; and

E) the customer must destroy or return all copies of the software to the licensor at the end of the license period. This provision is deemed to be met, in the case of a perpetual license, without being set forth in the license agreement.

In general, maintenance agreements that cover computer software and hardware are treated the same as maintenance agreements for other types of tangible personal property. The taxability of maintenance agreements is dependent upon whether the charge for the agreement is included in the selling price of tangible personal property. If the charge for a maintenance agreement is included in the selling price of tangible personal property, that charge is part of the gross receipts of the retail transaction and is subject to Retailers' Occupation Tax liability. No tax is incurred on the maintenance services or parts when the repair or servicing is completed.

If maintenance agreements are sold separately from tangible personal property, the sale of the agreement is not a taxable transaction. However, when maintenance services or parts are provided under the maintenance agreement, the company providing the maintenance or repair will be acting as a service provider under the Service Occupation Tax Act. The Service Occupation Tax Act provides that when a service provider enters into an agreement to provide maintenance services for a particular piece of equipment for a stated period of time at a predetermined fee, the service provider incurs Use Tax based upon its cost price of tangible personal property transferred to the customer incident to the completion of the maintenance service. See 86 Ill. Adm. Code 140.301(b)(3), enclosed.

Charges for updates of canned software are fully taxable pursuant to Section 130.1935. If the updates qualify as custom software under Section 130.1935(c), they are not taxable. But, if maintenance agreements provide for updates of canned software, and the charges for those updates are not separately stated and taxed, then the whole agreement would be taxable as sales of canned software.

Assuming that the services provided, such as installation, phone support, training, and seminars do not require the transfer of tangible personal property to the recipients of those services, charges for such services are exempt if they are separately stated from the selling price of canned software. See Section 130.1935(b). If computer software training or other support services are provided in conjunction with a sale of custom computer software or a license of computer software, the charges for that training are not subject to tax.

Determinations regarding nexus are very fact specific and cannot be made in the context of a General Information Letter. However, the following information provides some basic guidelines that may be used to determine whether a seller would be considered an "Illinois retailer" subject to Retailers' Occupation Tax liability or a "retailer maintaining a place of business in Illinois" subject to Use Tax collection duties from their Illinois customers.

An "Illinois retailer" is one who either accepts purchase orders in the State of Illinois or maintains an inventory in Illinois and fills Illinois orders from that inventory. The Illinois retailer is then liable for Retailers' Occupation Tax on gross receipts from sales and must collect the corresponding Use Tax incurred by the purchasers.

Another type of retailer is the "retailer maintaining a place of business in Illinois." The definition of a "retailer maintaining a place of business in Illinois" is described in 86 Ill. Adm. Code 150.201(I). This type of retailer is required to register with the State as an Illinois Use Tax collector. See 86 Ill. Adm. Code 150.801. The retailer must collect and remit Use Tax to the State on behalf of the retailer's Illinois customers even though the retailer does not incur any Retailers' Occupation Tax liability.

The final type of retailer is simply the out-of-State retailer that does not have sufficient nexus with Illinois to be required to submit to Illinois tax law. A retailer in this situation does not incur Retailers' Occupation Tax on sales into Illinois and is not required to collect Use Tax on behalf of its Illinois customers. However, the retailer's Illinois customers will still incur Use Tax on the purchase of the out-of-State goods and have a duty to self-assess their Use Tax liability and remit the amount directly to the State.

The United States Supreme Court in *Quill Corp. v. North Dakota*, 112 S.Ct. 1904 (1992), set forth the current guidelines for determining what nexus requirements must be met before a person is properly subject to a state's sales tax laws. The Supreme Court has set out a two-prong test for

nexus. The first prong is whether the Due Process Clause is satisfied. Due Process will be satisfied if the person or entity purposely avails himself or itself of the benefits of an economic market in a forum state. *Id*. at 1910. The second prong of the Supreme Court's nexus test requires that, if due process requirements have been satisfied, the person or entity must have physical presence in the forum state to satisfy the Commerce Clause.

A physical presence does not mean simply an office or other physical building. Under Illinois tax law, it also includes the presence of any representative or other agent of the seller. The representative need not be a sales representative and it is immaterial for tax purposes that the representative's presence is temporary.

In addition to the State Retailers' Occupation Tax, various local taxes may apply to a transaction. The Department's regulation set forth at 86 Ill. Adm. Code 320.115 explains the manner in which one determines if a local tax, and which local tax, is applicable to a transaction. As the regulation explains, local taxes are incurred when sales occur within a jurisdiction imposing a local tax. The Department has determined that the most important element of selling occurs when a seller accepts the purchaser's offer to buy. Consequently, selling is deemed to occur where the purchase order is accepted by the seller. It is the rate imposed by a jurisdiction at that location that will determine the correct amount of local taxes. The location of the purchaser, or the point at which title passes to the buyer, is immaterial.

If a purchase order is accepted outside this State but the tangible personal property which is sold is in an inventory of the retailer located within a local jurisdiction at the time of sale (or is subsequently produced in the local jurisdiction), then delivered in Illinois to the purchaser, the place where the property is located at the time of sale (or is subsequently produced in Illinois) will determine where the seller is engaged in business for purposes of that jurisdiction's local taxes with respect to such sale. See Section 320.115(b)(3).

I hope this information is helpful. The Department of Revenue maintains a Web site, which can be accessed at www.revenue.state.il.us. If you have further questions related to the Illinois sales tax laws, please contact the Department's Taxpayer Information Division at (217) 782-3336.

If you are not under audit and you wish to obtain a binding Private Letter Ruling regarding your factual situation, please submit all of the information set out in items 1 through 8 of the enclosed copy of Section 1200.110(b).

Very truly yours,

Martha P. Mote
Associate Counsel

MPM:msk
Enc.